A Dash of SALT

Fundamentals of Nexus in Arizona: Income Tax Nexus

This month's state and local tax (SALT) column introduces an additional hurdle that state and local governments must overcome, beyond the U.S. Constitutional limitations discussed in last month's column, before they may impose taxes on or measured by net income from interstate commerce, and the Arizona Department of Revenue's (ADOR's) interpretation of this federal law.

Last month's column introduced two important limitations on states' ability to impose taxes on proceeds from interstate and foreign commerce -- the "Due Process" clause, and the "Commerce Clause." Our founding fathers included these limitations in the U.S. Constitution, and they apply to all types of taxes.

In 1959, Congress exercised its prerogative to regulate interstate commerce by enacting Public Law 86-272, which provides an additional hurdle for states and local governments to overcome before they may impose taxes on or measured by net income from interstate commerce.

The Scope of Public Law 86-272

Public Law 86-272 generally prohibits states and local governments from imposing income taxes on taxpayers whose only in-state activity is the mere "solicitation of orders" for sales of tangible personal property.

For Public Law 86-272 protection to apply, the orders must be sent outside the state for approval or rejection and, if approved, the product must be shipped or delivered from a point outside the state.

Independent contractors may even maintain an office in a state and actually sell tangible personal property, rather than just solicit orders to sell, for a principal they represent and not exceed the protection provided by Public Law 86-272. However, they must represent more than one principal and hold themselves out as such in the regular course of their business activities in order to qualify as an independent contractor.

Limitations on Public Law 86-272

Although the protections afforded by the Due Process Clause and the Commerce Clause apply to all types of taxes, the additional protections afforded by Public Law 86-272 only apply to taxes imposed on or measured by net income. So, for example, pursuant to Public Law 86-272, a taxpayer may not be required to file an income tax return in a particular state, but the state might be able to force the taxpayer to collect and remit sales tax on the transactions that generated income in that state for the taxpayer.

Likewise, Public Law 86-272 only protects income derived from sales of tangible personal property. Thus, for instance, income from sales of services is not protected by Public Law 86-272.

And, Public Law 86-272 does not protect corporations that are incorporated in, or individuals who are domiciled in, a particular state from any tax imposed by that state.

ADOR's Guidelines Regarding Public Law 86-272

Like the taxing authorities in many other states, ADOR has interpreted Public Law 86-272 and issued guidance regarding specific activities that it believes are protected and unprotected by Public Law 86-272. ADOR's guidance is contained in Arizona Corporate Tax Ruling CTR 99-5, which is available on their website.

The ruling provides, for example, that some of the in-state activities that ADOR agrees will not cause the loss of protection for otherwise protected sales include:

1. Soliciting orders for sales by any type of advertising.
2. Soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain or use any office or other place of business in the state other than an "in-home" office as described . . . above.
3. Carrying samples and promotional materials only for display or distribution without charge or other consideration.
4. Furnishing or setting up display racks and advising customers on the display of the company's products without charge or other consideration.

5. Providing automobiles to sales personnel for their use in conducting protected activities.

6. Passing orders, inquiries, and complaints on to the home office.

Practice Tip! **–** Savvy CPAs help their clients distinguish between the types of activities that may create nexus for sales tax purposes yet are protected by Public Law 86-272. That way, their clients do not have to file income tax returns in more states than they need to. **AZ CPA**

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